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January 21, 1999

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

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Ms. Magalie Salas, Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
12th Street Lobby, Room TW-A325
Washington, D.C. 20554

In re Matter of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, **CC Docket No. 96-128**

Dear Ms. Salas:

On January 20, 1999, Professor Alfred Kahn and I spoke by telephone with William Rogerson of the FCC on behalf of the RBOC/GTE/SNET Payphone Coalition to discuss issues in the above-captioned proceeding. The purpose of the call was to explain the economic reasoning behind the Coalition's view that the capital costs associated with the payphone's coin mechanism are not an avoidable cost that can properly be excluded from the per-call compensation rate.

Professor Kahn explained that in determining the costs associated with coinless calls, economics requires that one consider the long run costs of providing for an increased number of such calls. In the long run, one will need to install more payphones to accommodate the increased volume of calls. If the most efficient type of payphone to install is a coin-capable phone, the additional payphones will be coin capable. Professor Kahn emphasized that this does <u>not</u> mean that coinless calls are bearing costs that are uniquely associated with coin calls — there is a causal incremental cost relationship between the additional <u>coinless</u> calls and the installation of <u>coin capable</u> payphones. Professor Kahn referred to his Declaration, submitted along with the Coalition's Comments on Remand (filed July 13, 1998), for a more detailed explanation. That excerpt is attached hereto.

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One original and one copy of this letter (along with the attachment) are being submitted to you in compliance with 47 C.F.R. § 1.1206(a)(2) to be included in the record of this proceeding. If you have any questions concerning this matter, please contact me at (202) 326-7921.

Sincerely,

Aaron M. Panner

Enclosure.

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C.

In the Matter of

Implementation of the Pay Telephone	)	CC Docket No. 96-128
Reclassification and Compensation	)	
Provisions of the	)	
Telecommunications Act of 1996	)	

COMMENTS ON REMAND ISSUES

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Counsel for the RBOC/GTE/SNET
Payphone Coalition

July 13, 1998

DECLARATION OF ALFRED E. KAHN

I, Alfred E. Kahn, do hereby declare as follows:

I. INTRODUCTION AND SUMMARY

The purpose of this affidavit is to support the Comments of the RBOC/GTE/SNET Payphone Coalition in the following respects:

1. It was reasonable for the Federal Communications Commission to have expressed confidence, in its Second Report and Order of October 9, 1997, "that market forces will keep the payphone prices at competitive levels...." (par. 118)

2. Given the legitimacy of that finding, it was both economically efficient and fully compliant both with the general intention of the Telecommunications Act to establish a "pro-competitive deregulatory national policy framework" and with its explicit instruction to "establish a per call compensation plan to ensure that all payphone service providers are fairly compensated for each and every completed...call using their payphone"[1] for the Commission to base its prescribed default rate for 800 and dial-around calls on the observed market price for coin calls, and then

3. to adjust that market price for any differences between the avoidable or incremental cost of those services and the coin calling services to which the observed market rate applies.

[1] Section 276 (b)(1).

- Regulatorily-prescribed, cost-based rates tend inherently to be based on cost averages, which in turn tend inevitably to obscure cost-justified differentials—for example, higher rates in remote and lightly-used locations—which efficiency requires be reflected in prices, in order to encourage the deployment of payphones in higher-cost locations. Those rate differentials would in competitive markets continue to be constrained by the relative ease of competitive entry.

IV. Adjustments of the Market Rate For Non-Coin Calls

Since the putatively competitively-determined cost-based market rate, upon which the FCC proposes to base the regulated rate for these non-coin services, has been established in the market for coin services, clearly the economically efficient as well as—by traditional regulatory standards—equitable treatment of the coin rate would be to adjust for any differences between the incremental costs of the two categories of services.

Since I have not myself undertaken a study of what those cost differences might be, I confine myself to commenting on the logic underlying the particular adjustments that the FCC has made and some objections to these posed by the several parties.

A. Costs peculiarly associated with coin calls

Since the major apparent difference between the costs associated with the coin- and non-coin calls are the ones associated with coin-collection—both the capital costs associated with their incorporation in the equipment, the maintenance peculiarly associated with that feature (including, prominently, costs associated with theft and tampering) and the operating costs of collecting the coins—the most important adjustment of the 35 cent market rate proposed by the FCC, under instructions from the Circuit Court of Appeals, is to deduct the apparently avoidable costs associated with that feature. The logic of the adjustment is clear: in imperfectly or purely competitive markets, the prices of services supplied in common will differ by the differences in their several incremental costs.[11]

The major outstanding issue with respect to this adjustment is whether the FCC was correct in deducting the incremental capital costs of equipping the payphones with coin-collection capabilities.

The Coalition objects to the subtraction of all but the variable costs of coin collections on the ground that any and all payphones have been and will for the foreseeable future continue to be equipped with those capabilities: that, to put it another way, few if any payphones would be installed if not for coin calling; these capabilities are inherent and, so far as can be foreseen, inescapable characteristics of the facility.

If the facts are as they state them, their objection is justified. If, that is to say, the costs of payphones associated with coin collection capabilities would be altered neither more nor less if, *within the likely range*,[12] many more or many fewer non-coin calls were placed, the fixed

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[11] Observe, once again, that this generalization about the efficient pricing of common products applies—Dr. Warren Boulton's assertions notwithstanding—regardless of whether they are independent or substitutable for one another.

Where, because of the presence of economies of scale or scope, prices set only at incremental costs will produce inadequate total revenues, they will differ also in reflection of differences in the elasticity of their several demands. In the absence of a demonstrated justification for larger or smaller differentials, on demand elasticity grounds, the economic and regulatory presumption would be in favor of price differentials equal to differences in incremental costs, in which situation the several common services would make the same contribution per unit to the recovery of common costs.

[12] Manifestly, if the number of coin calls were to decline sufficiently drastically and/or of non-coin to increase correspondingly drastically, different kinds of payphones, with differing cost characteristics, might well be installed. But the relevant question, from the standpoint of efficient price, is not a purely hypothetical one: it is how costs will or would *in fact* change if the proportions of the two kinds of calls were to change within the

costs associated with the coin-collection mechanism are neither more nor less avoidable costs of coin than of non-coin calls. Since they are, therefore, not in fact truly incremental or avoidable costs of non-coin calls, no economic purpose is served by differentiating the charges for the two categories of calls on this account.

Since the foregoing reasoning may be counterintuitive—may, indeed, strike one as unjust (how can it be fair to charge the people who assume responsibility for non-coin calls the fixed costs associated with the coin-collection mechanism?), it may be useful to remind ourselves of the economic purpose of prices reflecting and incorporating avoidable costs. It is to require buyers to decide whether the incremental costs to society of their demanding more of the service in question—or the costs that society would avoid if they ceased to demand it, either entirely or in smaller decrements—are equaled or exceeded by the satisfaction they derive from those purchases. This logic extends to capital costs as well as operating costs, of course: to the extent that incremental usage of the payphones increases the need—or increasing usage brings closer the day of need—for replacement or for additional payphone capacity, imposing those capital costs on users serves the familiar purpose of economic efficiency, requiring them to weigh against the additional benefits they receive for placing those calls the cost that society will actually incur maintaining and expanding that capacity. In the present context, the pertinent question is whether the incremental capacity costs imposed by coin usage differ from the incremental costs imposed by usage for non-coin calls; and here, if its factual premise is correct, it would appear the reasoning of the Coalition is correct and that of the FCC incorrect. If—*within any realistic range* (observe, once again, the essential factual component of the

realistically relevant range. That is why the foregoing exposition begins with the qualification, "If the facts are exercise)—the same kind of payphones, with the same capital costs, would be or would not be installed regardless of whether the additional calls placed or not placed were coin or non-coin, then no economic purpose is served by charging different prices for the two on this account. Conceivably if the increments in demand over time were exclusively or preponderantly for non-coin calls, replacements or expansions in their numbers might take the form of payphones lacking the coin-collecting capabilities. But so long as the realistic assessment is that the additional capacity will be provided in the form of the traditional payphone, with coin collecting capability, the causal responsibility of coin- and non-coin calls for society incurring those costs will be identical: they will be the capital costs of payphones with that capability.

To the extent that there are or would be operating costs—costs of maintaining the coin mechanism and collecting the coins—that would actually vary with coin but not non-coin usage, it would indeed be inefficient (as well as inequitable) to impose them on placers of non-coin calls. I observe that the FCC does indeed adjust the 35 cent market rate downward in setting the default rates at issue in this proceeding to exclude those costs; and the Coalition does not object.[13]

The proposition that users of a common facility who do not need one costly feature of the service it provides be required to pay the same price as other users who do require that

as they state them."

[13] By the same logic as we have expounded with respect to capital costs, however, unless it can be argued that the susceptibility of payphones to tampering, breaking and entering in order to get at the cash will *vary* depending upon the proportion of cash and non-cash calls, there is no *economic* basis for excluding non-coin calls from sharing in those costs, however unfair it might seem: those costs will vary with the number of payphones, which will vary in turn with the number of calls, coin and non-coin alike.

feature may well strike a non-economist as in some sense unfair. That kind of reasoning might suggest, instead, some method of allocating the common costs among the different categories of users in proportion to the separate costs of serving them severally with facilities uniquely suited to the demands of each. This was the essence of the "alternative justifiable expenditures" method devised by the Tennessee Valley Authority for allocating the common costs of multi-purpose river development projects among the several services supplied—electric power, navigation, flood control—

> in proportion to what it *would* have cost to provide each of those services in the same quantity in single-purpose projects set up exclusively for them,

as I described it roughly in my *The Economics of Regulation.*[14]

As I pointed out in so describing that method, however, the similar, so-called "relative cost method" for allocating the cost of producing natural gas and oil and various natural gas liquids in common in order to ascertain a "just and reasonable" field price for the natural gas:

> while it might be deemed to provide a just or a fair distribution of the joint costs, it did not provide an economic measure of the separate costs.[15]

In purely economic terms—in terms, that is, of marginal causal responsibility—there is no difference between coin- and non-coin calls in their respective responsibilities at the margin for society's incurring these capital costs—if, to repeat, the Coalition's factual premise is sound.

William Shew and I confronted the identical problem many years ago, in posing the question:

> Why should the humble POTS customer be required to pay a price set at marginal costs that have been elevated by the demand for such exotic services as

[14] New York: John Wiley & Sons, 1970, 1971, reprinted MIT Press, 1988, Vol. 1, p. 151.

[15] *Ibid.*, Vol. 1, p. 151, note 67.

> actually *using* the telephone to place or receive calls, local or long-distance, or to make possible high speed data transmission? Why not reflect the asserted differences in the costs of designing access systems suitable respectively for local calling, long-distance calling, and more sophisticated services in correspondingly differing flat monthly charges to customers depending on the kind of service to which they wish to subscribe?

Our answer was:

> Competitive markets have the virtue of offering consumers a variety of price and quality options, but that spectrum of offerings is not unlimited. It is not economically feasible to provide all conceivable packages. For example, there may be some automobile buyers who would prefer to buy cars without bumpers or fenders, at a correspondingly reduced price; but in view of the economies of producing standardized models, it probably would actually be more costly to satisfy their idiosyncratic desires than to supply them with the models preferred by the great majority of customers. In that event, they have no legitimate complaint about not having available to them, at a lower price, a stripped-down version that would have to be custom-made. ...
>
> Similarly, it may well be infeasible to supply the minority of subscribers who have no desire to be connected to the interexchange network, *either* to place or to receive long-distance calls, with the limited service they want except at costs that they themselves would regard as excessive. The system may therefore have to be designed with the facilities and quality of service that maximize the net benefits to all subscribers collectively....
>
> The kind of telephone network that we have, in short, inevitably represents a *collective consumption decision.* Because it would probably have been impractical for telephone companies to offer two or more systems, of varying capability, it became necessary to decide, *in effect* collectively, which quality offered the largest differential between benefits and costs to all subscribers together.[16]

[16] Alfred E. Kahn and William B. Shew, "Current Issues in Telecommunications Regulation: Pricing," *Yale Journal on Regulation*, Vol. 4, No. 2, Spring 1987, pp. 229-31.

Similarly, we rejected claims that "the telephone companies are attempting illegitimately to load on to POTS customers a portion of the costs of upgrading their non-traffic-sensitive access networks in order to offer various sophisticated services. The first question is *whether those investments are economically efficient*, minimizing the combined costs of access, calling, and the newer services....If the expenditures are efficient—that is, if they conduce to the efficient design of the entire system—then the marginal costs of the several services at which their prices should be set are their marginal costs under that system. Specifically, if the efficient system entails a higher proportion of NTS subscriber plant costs than some other design, the economically first-best flat rates to POTS customers will reflect those higher costs: The marginal costs of access are what they are in the system that is optimally designed to satisfy all demands it serves." *Ibid.*, p. 228.

The identical economic reasoning would seem clearly to apply to coin- and non-coin calls: no economic purpose is served by deducting from the charges providers of payphone receive from the placing of non-coin calls costs that would not be avoided if they reduced the amount of their calling—costs society will indeed incur as the volume of those calls grows, regardless of the way in which those incremental volumes will *in fact* be distributed between those two categories of calls.

B. The issue of rounding

One basis for the objection of the long-distance carriers to the Commission's basing the rates for non-coin services on the market rate for coin calls is that it fails to take into account the fact that

> rates for...[the latter] calls must be rounded to the nearest nickel or dime. Thus, for example, even if the local coin market otherwise functioned perfectly...if the rate at which that market would come to rest is 33 cents, PSPs will not charge 33 cents; they will round, presumably to a 35 cent rate.[17]

The fatal inadequacy of their argument is that they offer no basis for their obvious supposition that the necessary rounding would, typically or on average, be upward rather than downward. If the market for coin calls were effectively competitive, the roundings upward would be balanced or offset, systematically, by the roundings downward. Prices would move by 5 cent intervals; but if the roundings were asymmetrically upward, as the objections implicitly assume, the incumbent firms would earn supernormal profits, which entry would undermine—with users of the service benefiting from a combination of restraint on the charges

[17] MCI et al., *Certificate, op. cit.*, p. 18.